FILED
JUL 9 - 2008
OFFICE OF THE CLERK
SUPREME COURT, U.S.

No. 07-1526

IN THE

Supreme Court of the United States

CEMCO INVESTORS, LLC AND
FOREST CHARTERED HOLDINGS, LTD.,

Petitioners,

v.

UNITED STATES OF AMERICA,

Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS
FOR THE SEVENTH CIRCUIT

BRIEF *AMICUS CURIAE* OF STOBIE CREEK INVESTMENTS, LLC IN SUPPORT OF PETITIONER

NEIL LLOYD
SCHIFF HARDIN LLP
6600 Sears Tower
Chicago, IL 60606
(312) 258-5628

ROBERT E. KOLEK
Counsel of Record
SCHIFF HARDIN LLP
6600 Sears Tower
Chicago, IL 60606
(312) 258-5755

Counsel for Amicus Curiae
Stobie Creek Investments, LLC

216818

COUNSEL PRESS
(800) 274-3321 • (800) 359-6859

TABLE OF CONTENTS

	Page
TABLE OF CITED AUTHORITIES	ii
INTEREST OF AMICUS CURIAE	1
REASONS FOR GRANTING REVIEW	3
I. REVIEW IS WARRANTED TO RESOLVE THE THREE-WAY CONFLICT.	3
A. The Conjunctive Test	4
B. The Disjunctive Test	6
C. The Unitary Test	8
II. APPLICABILITY OF THE VALUATION - MISSTATEMENT PENALTY	10
CONCLUSION	11

TABLE OF CITED AUTHORITIES

Page

Cases

ACM Partnership v. Comm., 157 F.3d 231 (3d Cir. 1998) 8, 9

Black & Decker, 436 F.3d 441 (2006) 4

Casebeer v. Comm., 909 F.2d 1360 (9th Cir. 1990) 8, 9

Cemco Investors, LLC and Forest Chartered Holdings Ltd. v. United States, 515 F.3d 749 (7th Cir. 2008) 3, 6

Coltec Indus., Inc. v. United States, 454 F.3d 1340 (Fed. Cir. 2006) 6, 7

Dow Chem. Co. v. United States, 435 F.3d 594 (6th Cir. 2006) 7

Frank Lyon Co. v. United States, 435 U.S. 561 (1978) 3, 4, 8

Golsen v. Comm., 54 T.C. 742 (1970), *affd*, 445 F.2d 985 (10th Cir. 1971) 9

Gregory's v. Helvering, 293 U.S. 465 (1935) 9

Horn v. Comm., 968 F.2d 1229 (D.C. Cir. 1992) ... 4, 5

Cited Authorities

	Page
In re CM Holdings, Inc., 301 F.3d 96 (3d Cir. 2002)	9
James v. Comm., 899 F.2d 905 (10th Cir. 1990)	8
Kirchman v. Comm., 862 F.2d 1486 (11th Cir. 1989)	7
Northern Indiana Public Service Co. v. Comm., 115 F.3d 506 (7th Cir. 1997)	5, 6
Rice's Toyota World, Inc. v. Comm., 752 F.2d 89 (4th Cir. 1985)	4
United Parcel Serv. of Am., Inc. v. Comm., 254 F.3d 1014 (11th Cir. 2001)	7
Winn-Dixie Stores, Inc. v. Comm., 254 F.3d 1313 (11th Cir. 2001)	6
Statutes	
26 U.S.C. § 6231	10
26 U.S.C. § 6662	2, 3, 9, 11
Treas. Reg. § 1.752-6	1, 2, 6

Cited Authorities

Page

Other Authorities

Eileen J. O'Conner, *Enforcement Is Progressing, Justice Department Attorney Testifies At Senate Finance Hearing*, 114 Tax Notes 42 (June 14, 2006) 2

Karen N. Moore, *The Sham Transaction Doctrine: An Outmoded and Unnecessary Approach to Combating Tax Avoidance*, 41 Fla. L. Rev. 659 (1989) 5

Korb Acknowledges U.S. Supreme Court May Need to Clarify Economic Substance Doctrine, Daily Tax Rep. (BNA) (October 27, 2006) 4

INTEREST OF AMICUS CURIAE[1]

Stobie Creek is filing this amicus brief because it has a case pending in the U.S. Court of Federal Claims, *Stobie Creek Investments LLC v. United States*, No. 05-748, which concerns similar questions of economic substance and penalties. The Claims Court in *Stobie Creek* recognizing the importance of the *Cemco* decision, requested post-trial briefing on the decision in *Cemco*, albeit concerning Treas. Reg. § 1.752-6. Evidence has closed and post-trial briefing has been completed in the *Stobie Creek* matter and the parties are awaiting a decision.

Stobie Creek was formed in 2000 to hold a family's combined investments before and upon the sale of half of their family business. In March 2000, the Stobie Creek members, through their respective LLCs and a Family Trust, transferred foreign currency options to Stobie Creek. They did so expecting a profit on their investment. In reporting income for the year 2000, Stobie Creek and its members determined their income consistent with the then-applicable Internal Revenue Code and Treasury regulations. Upon audit, the IRS increased Stobie Creek's income, and consequently its

---

[1] Pursuant to Supreme Court Rule 37.6, *amicus* states that the brief was authored in its entirety by *amicus curiae* and its counsel. No monetary contribution toward the preparation or submission of this brief was made by any person other than *amicus curiae*, its members and its counsel. By letters filed with the Clerk of the Court, petitioner and respondent have consented to the filing of this brief and have been given at least 10 days notice of such filing.

members', relying in substantial part on the economic substance doctrine and the retroactive application of Treas. Reg. § 1.752-6.

Stobie Creek is vitally affected by and interested in the determination of the proper tests for economic substance and application of the valuation-misstatement penalty under 26 U.S.C. § 6662. Countless other taxpayers are similarly situated.

This Court's review now is important because of the IRS's increasing aggressiveness in asserting that transactions lack economic substance whenever a taxpayer attempts to structure a transaction to secure favorable tax consequences. *See* Eileen J. O'Conner, *Enforcement Is Progressing, Justice Department Attorney Testifies At Senate Finance Hearing*, 114 Tax Notes 42 (June 14, 2006). Taxpayers, like Stobie Creek, need to be able to predict *ex ante*, and with reasonable certainty, the tax consequences of transactions they contemplate.

As one among many partnerships whose partners contributed contingent liabilities, Stobie Creek respectfully files its amicus brief, urging that this Court clarify the scope and validity of the economic-substance doctrine and the application of 26 U.S.C. § 6662, resolving current conflict among the federal appellate courts.

PRELIMINARY STATEMENT

Petitioners seek review of *Cemco Investors, LLC and Forest Chartered Holdings Ltd. v. United States*, 515 F.3d 749 (7th Cir. 2008), on the ground that the federal appellate courts disagree about the proper economic substance test and on application of 26 U.S.C. § 6662, the valuation-misstatement penalty. Stobie Creek, as amicus curiae, urges that the Court grant review to clarify the proper test for determining whether a transaction has economic substance. The appellate courts are profoundly divided on the proper economic substance and for determining the application of the valuation misstatement penalty standard — indeed, two circuits apply a "conjunctive" test, three apply a "disjunctive" test, and other courts apply a "unitary" test. Additionally, the appellate courts are divided on the proper application of the valuation misstatement penalty.

REASONS FOR GRANTING REVIEW

I. REVIEW IS WARRANTED TO RESOLVE THE THREE-WAY CONFLICT.

In *Frank Lyon Co. v. United States*, 435 U.S. 561, 583-84 (1978), the Court held that the Government must honor "a genuine multi-party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax independent considerations, and is not shaped solely by tax avoidance features that have meaningless labels attached." Since that decision, the courts of appeals have developed three divergent and non-harmonious standards under the

economic-substance doctrine. Specifically, they have divided over whether this Court has mandated a "conjunctive," "disjunctive," or "unitary" test. Indeed, the IRS's chief counsel has acknowledged the three-way split, noting that it invites this Court's intervention. *Korb Acknowledges U.S. Supreme Court May Need to Clarify Economic Substance Doctrine*, Daily Tax Rep. (BNA) (October 27, 2006), at pp. 2-3.

A. The Conjunctive Test

The Fourth and D.C. Circuits have adopted a two-prong "conjunctive" test. The Fourth Circuit has held: "To treat a transaction as a sham, the court must find that the taxpayer was motivated by no business purpose other than obtaining tax benefits in entering the transaction, *and* that the transaction has no economic substance because no reasonable possibility of profit exists." *Rice's Toyota World, Inc. v. Comm.*, 752 F.2d 89, 91 (4th Cir. 1985) (emphasis added). In light of *Frank Lyon*, 435 U.S. 561, the Fourth Circuit concluded that "a transaction cannot be treated as a sham *unless* the transaction is shaped *solely* by tax avoidance considerations." *Rice's Toyota World*, 752 F.2d at 92 (emphases added); *Black & Decker*, 436 F.3d at 441.

The D.C. Circuit has adopted the same rule, noting that "[t]he Supreme Court's approach in [*Frank Lyon* and *United States v. Consumer Life Ins. Co.*, 430 U.S. 725 (1977)] demonstrates the separability of the 'business purpose' and the economic gain tests." *Horn v. Comm.*, 968 F.2d 1229, 1238 (D.C. Cir. 1992). "[A] transaction undertaken for a nontax business purpose will not be considered an economic sham even if there was no

objectively reasonable possibility that the transaction would produce profits." *Id.* at 1237 (emphasis omitted); *Id.* at 1237-38

> "'The test inquires into the existence of a business purpose for the transaction and evaluates the economic substance of the transaction. The latter evaluation is to be guided by a more precise test of whether there is a reasonable possibility of a profit. Only if neither test were satisfied would the transaction be considered a sham transaction.'"

(quoting Karen N. Moore, *The Sham Transaction Doctrine: An Outmoded and Unnecessary Approach to Combating Tax Avoidance*, 41 Fla. L. Rev. 659, 670 (1989)).

The Seventh Circuit appeared to have adopted the conjunctive test in *N. Indiana Public Serv. Co. v. Comm.*, 115 F.3d 506 (7th Cir. 1997) ("*Nipsco*"). There, the taxpayer formed a Netherland Antilles subsidiary corporation to obtain access to lower cost financing from foreign investors. By using a Netherland Antilles subsidiary to borrow in the European Market, the taxpayer obtained tax advantages through direct borrowing in that Market. The Commissioner, however, challenged the interest transactions between taxpayer and its subsidiary based on the taxpayer's tax-avoidance motive in creating this subsidiary. Specifically, the Commissioner argued that transactions lacking economic substance between related legitimate corporations could be disregarded. The Seventh Circuit

disagreed: "[I]t is unnecessary, and we think inappropriate for us to sever a corporation from its transactions in analyzing a case, such as this one, where the corporation was formed with the intent of structuring its economic transactions to take advantage of laws that afford tax savings." *Nipsco*, 115 F.3d at 512. Instead, the court endorsed "the principle that a corporation *and the form of its transactions* are recognizable for tax purposes, despite any tax-avoidance motive, so long as the corporation engages in bona fide economically-based business transactions." *Id.*

Here, however, the Seventh Circuit disregarded *Nipsco*, concluding instead that the transaction at issue "seem[ed] to lack economic substance." *Cemco*, Pet.App.4. And, departing from the conjunctive test, the court relied on *Coltec Indus., Inc. v. United States*, 454 F.3d 1340 (Fed. Cir. 2006), finding that Treas. Reg. § 1-752-6 "instantiate[d] the pre-existing norm that transactions with no economic substance don't reduce people's taxes." *Cemco*, Pet.App. 7-8. This unannounced renunciation of the "conjunctive" test adds confusion to the issue of the proper analysis to be employed and is a further reason for granting review.

B. The Disjunctive Test

A second group of circuits (the Sixth, Eleventh, and Federal Circuits) have adopted a "disjunctive" test for economic substance. Under this test, the absence of *either* objective economic substance or subjective business purpose is fatal to the transaction. For example, the Eleventh Circuit, in *Winn-Dixie Stores, Inc. v. Comm.*, 254 F.3d 1313, 1316 (11th Cir. 2001), stated that

the "sham-transaction doctrine . . . provides that a transaction is not entitled to tax respect if it lacks economic effects or substance other than the generation of tax benefits, *or* if the transaction serves no business purpose." (Emphasis added). Additionally, "[o]nce a court determines a transaction [has no economic effects], no further inquiry into intent is necessary." *Kirchman v. Comm.*, 862 F.2d 1486, 1492 (11th Cir. 1989). Alternatively, "[e]ven if the transaction has economic effects, it must be disregarded if it has no business purpose and its motive is tax avoidance." *United Parcel Serv. of Am., Inc. v. Comm.*, 254 F.3d 1014, 1018 (11th Cir. 2001) ("*UPS*").

Similarly, the Sixth Circuit has held:

> 'The proper standard in determining if a transaction is a sham is whether the transaction has any practicable economic effects other than the creation of income tax losses.' If the transaction has economic substance, 'the question becomes whether the taxpayer was motivated by profit to participate in the transaction.' 'If, however, the court determines that the transaction is a sham, the entire transaction is disallowed for federal tax purposes, and the [subjective] inquiry is never made.'

Dow Chem. Co. v. United States, 435 F.3d 594, 599 (6th Cir. 2006) (internal citations omitted, alteration in original, emphasis added). The Federal Circuit follows the same disjunctive test. *Coltec Indus. Inc. v. United States*, 454 F.3d 1340, 1355 (Fed. Cir. 2006) ("[A] lack of

economic substance is sufficient to disqualify the transaction without proof that the taxpayer's sole motive is tax avoidance."). Under this rule, an objective determination of lack of economic benefits alone is enough to disallow a transaction for tax purposes.

None of these courts' expressions of the disjunctive test is consistent with *Frank Lyon*, 435 U.S. 561. Indeed, to the extent that each formulation negates having to make a "subjective inquiry," it ignores *Frank Lyon*.

C. The Unitary Test

The Third, Ninth, and Tenth Circuits apply yet another test: the "unitary" test. In *ACM Partnership v. Comm.*, 157 F.3d 231 (3d Cir. 1998), the Third Circuit held: "[t]he inquiry into whether the taxpayer's transactions had sufficient economic substance to be respected for tax purposes turns on both the 'objective economic substance of the transactions' and the 'subjective business motivation' behind them." *Id.* at 247 (quoting *Casebeer v. Comm.*, 909 F.2d 1360, 1363 (9th Cir. 1990)); *accord James v. Comm.*, 899 F.2d 905, 908-909 (10th Cir. 1990) (viewing "business purpose and economic substance" as "factors to consider" in its economic substance analysis). These courts expressly reject the "conjunctive" test. *Casebeer*, 909 F.2d at 1363 (holding that the Fourth Circuit analysis "has no merit" because "the Court's holding in *Frank Lyon was not intended to outline a rigid two-step analysis*") (emphasis added); *James*, 899 F.2d at 908-909 (finding the Ninth Circuit to have a "better approach" than the

Fourth Circuit). The Third Circuit offered the following explanation for diverging from the "conjunctive" test:

> [the] distinct aspects of the economic sham inquiry do not constitute discrete prongs of a 'rigid two-step analysis,' but rather represent related factors both of which inform the analysis of whether the transaction had sufficient substance, apart from its tax consequences, to be respected for tax purposes.

ACM, 157 F.3d at 247 (quoting *Casebeer*, 909 F.2d at 1363).

The "unitary" test departs from the "disjunctive" test in that a finding of lack of objective economic substance does not end the inquiry. As support, the courts have reasoned that: "From the time of *Gregory's* [*v. Helvering*, 293 U.S. 465 (1935)] analysis of the 'rational business purpose,' courts have evaluated taxpayers' purposes when determining whether a transaction has economic substance." *In re CM Holdings, Inc.*, 301 F.3d 96, 106 (3d Cir. 2002).

CM Holdings, in particular, shows why this Court's intervention is imperative to ensure the federal tax laws are uniformly administered. Both among the various appellate courts — and within the Seventh Circuit itself — there is a profound lack of coherence. Taxpayers need to be able to predict, with reasonable accuracy, the tax consequences of transactions they contemplate.

II. APPLICABILITY OF THE VALUATION – MISSTATEMENT PENALTY

The Petition also notes a split among the circuits regarding the applicability of the valuation – misstatement penalty. The Fifth and Ninth Circuits follow the rule that when the underpayment of tax results from a disallowance of a deduction or credit, it is not considered attributable to a valuation overstatement, and the 26 U.S.C. § 6662 penalty accordingly does not apply. The Third, Fourth, Sixth and Eighth Circuits, and now the Seventh Circuit, however, reach the opposite conclusion.

In the case of partnerships not subject to the unified audit and judicial procedures,[2] which have partners residing in several jurisdictions, the split between the circuits can lead to inconsistent rulings on the same facts. Partners in a small partnership will be subject to individual audits with final determinations governed by the law of the Circuit to which an appeal would be made. See *Golsen v. Comm.*, 54 T.C. 742 (1970), *aff'd* 445 F.2d 985 (10th Cir. 1971).

Thus, if a partnership had partners in each of the Third, Fifth, Seventh and Ninth Circuits, the valuation misstatement penalty could be applied against those residing in the Third and Seventh Circuits, but not those

---

[2] Generally, partnerships are audited by and disputes with the IRS are resolved pursuant to the unified procedures set forth in 26 U.S.C. §§ 6221 *et seq.* But small partnerships, as defined in 26 U.S.C. § 6231(a)(1)(B), are excluded from the unified procedures unless the partnership elects to be included within those procedures.

residing in the Fifth and the Ninth Circuits. This anomalous result occurs because of the courts' divergent approaches regarding whether, for purposes of 26 U.S.C. § 6662, an understatement of tax is "attributable to" a valuation misstatement as a consequence of the court's disallowance of a deletion or credit.

CONCLUSION

Consistency among the appellate courts regarding the proper test for determining whether a transaction has economic substance is vital to the proper administration of the tax laws. Consistency is also needed concerning the proper interpretation of 26 U.S.C. § 6662. In the present climate, however, taxpayers face inconsistent rules governing even straightforward transactions. The federal courts are profoundly divided — and the issues have crystallized, presenting an ideal vehicle for this Court's review. For the reasons set forth above, amicus curiae Stobie Creek urges the Court to grant review.

Respectfully submitted,

NEIL LLOYD
SCHIFF HARDIN LLP
6600 Sears Tower
Chicago, IL 60606
(312) 258-5628

ROBERT E. KOLEK
Counsel of Record
SCHIFF HARDIN LLP
6600 Sears Tower
Chicago, IL 60606
(312) 258-5755

Counsel for Amicus Curiae
Stobie Creek Investments, LLC